With the growing prominence of Asian financial markets, we often are asked, “How much should I allocate to Asia?” While the answer to this question is not a simple one, we weigh in below with our thoughts on how Asia fits within a globally diversified portfolio.

A Point of Reference

Typically a first step in designing a global portfolio is deciding how much to have invested within and outside of the United States. It’s useful to have a neutral reference point to help determine this target.

An obvious approach might be to start with an established benchmark as a frame of reference. Some argue that the United States accounts for more than 40 percent of world stock-market value. In fact, the United States accounted for 41 percent of the MSCI AC World Index at the end of 2009. However, the United States accounted for only about 31 percent of the world stock-market value at the end of 2009. Why the difference? Investability. Index providers focus on creating benchmarks that are representative and investable, not all-encompassing. For example, China’s domestic A-share market and most small companies are excluded from standard global benchmarks.

Total world stock-market value could be a good neutral frame of reference, except for the risk that bedevils capitalization-weighted construction—i.e., you potentially overweight overvalued markets. For example, Japan accounted for a third of the world’s market value at its 1990 stock-market peak. While we certainly don’t intend to wade into the fundamental vs. market-cap weighting debate, we’ll suggest another alternative—economic size. According to this measure, the United States is 25 percent of global gross domestic product (GDP). Even with GDP-based schemes you can debate weightings based on purchasing power exchange rate vs. current exchange rate. However, figure 1 shows one of the potential advantages of a GDP approach: The weightings are not affected by overvaluation or short-term market momentum, so you would have had a higher exposure to Asia when valuations were low during the Asian financial crisis at the end of 1997. Using this approach would have underweighted Japan relative to a market-cap-based weighting back at its peak in 1990. Given the amazing growth of Asia in the past decade, one may be surprised to see that the region represents a similar proportion of the world economy today. Asia Pacific is 29 percent of global GDP, not much higher than its 26 percent weighting 10 years ago. Such is the effect of the stagnation of Japan, formerly Asia’s largest economy. In 1999, Japan made up 14 percent of global GDP—or more than half of Asia Pacific’s total. Today’s Asia Pacific breakdown is more diversified across developed and emerging economies, with 9 percent from Japan, 9 percent from China, 2 percent from India, and 9 percent from the rest of the region. One should note that the data do not use purchasing power parity, so arguably it understates the actual economic relevance of China and India.
The bottom line in this analysis? There is no one ideal point of reference. It is useful to use a combination of reference points when comparing the resulting regional allocations of investment portfolios.

Implementing Globally Diversified Portfolios

There are more ways of implementing a globally diversified portfolio than there are days in a year. The most common approach is to achieve targeted international equity weightings using a combination of developed international strategies that are aligned with the MSCI EAFE (Europe, Australasia, Far East) Index and global emerging markets strategies that are aligned with the MSCI EM (Emerging Markets) Index. Whether the strategies are implemented with index funds, exchange-traded funds (ETFs), or active managers, the resulting regional allocations will likely fall within a fairly similar band.

What does following this implementation approach mean for an investor’s exposure to Asia? How does that compare to our chosen world stock indexes, total stock market value, and global GDP?

Let’s assume a portfolio has a relatively high international component at 35 percent. Of this amount, 25 percent is invested in developed-market-focused international equity (MSCI EAFE benchmarked) and 10 percent is invested in emerging market equity vehicles (MSCI EM benchmarked). This leaves the investor with anywhere from 5 percent to 15 percent in Asia Pacific. So the portfolio has about half of our reference weightings of the MSCI AC World Index, total world stock-market value, and global GDP.

Moreover, it is likely that the largest part of the Asia Pacific allocation will be to Japan—which despite two decades of stagnation remains significant in Asia Pacific’s total GDP, total stock-market value, and world stock indexes. But what exposure does the portfolio have in Asia’s fastest-growing economies of China and India? You might be surprised to learn that this 35-percent internationally invested portfolio has just more than a 3-percent exposure to China and India combined. Thus, our contention is that many U.S. investors are underweight in the Asia region. This is especially an issue if Asia—led by China and India, in particular—continues to have higher economic growth rates relative to the United States and Europe.

The Strategic Bias of Benchmarks

We use benchmarks as our asset allocation tools. They are meant to represent the markets we invest in, and they do a pretty decent job. However, with the proliferation of ETFs, more people are using the benchmark as the investment. That is to say, the allocation within the benchmark becomes the allocation within the portfolio. This can introduce biases into the portfolio, which can be particularly noticeable in countries where the economic landscape is changing, even if it is changing in predictable ways.

We believe that the evolution of Asian economies and markets, particularly in terms of their sector composition, will move toward that of the United States over time. This is not some inevitable historical trend without micro-foundations. As people become wealthier, they want to spend more money consuming or enjoying leisure time. Thus, the industries that make up the consumer part of the economy are going to grow in size and value compared with those that make up sectors such as heavy industries.

It is important to remember that benchmarks are not forward-looking. They are an imperfect expression of what the economy or market looks like today. They are the result of an accumulation of past decisions. These decisions may be based partly on an expectation of the future but they are, to a large extent, framed or anchored by the knowledge of the certain past. Asset allocation is about getting away from the straightjacket of how the world looks today and making sensible judgments about the future.

To us, it seems clear that the underlying growth of Asia—the growth that likely will lead the world over the next five years—is going to be of a different kind and quality than we’ve seen in the past. Much more of it will be focused on developing the consumer and domestic markets within Asia. This has implications that will affect stock selection and asset allocation.

With domestic growth, competition will probably favor local players. Already, we are seeing Asian companies develop their brands along with the marketing skills to build protective moats around their businesses. This has huge implications for the long-term returns that can be generated from single investments. It will impact the companies that investors select. And yet, when we look at the allocation to sectors within the current markets, they bear little resemblance to where we can postulate they might be in 10 years by looking at the composition of Western markets.

The other more general point about focusing so strongly on geographic asset allocation for international portions of one’s portfolio is that it ignores the fact that stock selection strategies are generally more effective in markets that are less efficient. Therefore, a bottom-up strategy can be more effective when pursued in an Asian market than a Western one. Strategy is also seldom considered in international mandates, whereas it is a very important part of allocation from the U.S. investor’s standpoint, even though those strategies may be more effective overseas. These differences seem linked to a concept of “developed versus emerging,” a concept that might once have been useful but now seems to have run its course. In its place, a process that takes account of contributions to GDP is a useful starting framework.
Developed or Emerging—and Does It Matter?

With the fall of the Berlin Wall in 1989, the phenomenon of emerging markets caught on, and the MSCI Global Emerging Markets Index became the benchmark for U.S. investors exploring beyond the original MSCI EAFE developed markets. The vast majority of countries beyond the United States, Western Europe, and Japan had a GDP per capita level defined as “emerging markets,” according to the World Bank. However, significant events of the past 20 years have perhaps caused the strict classification between “developed” and “emerging” markets to lose relevance in the investment construct.

In Asia, the rapid economic growth of Hong Kong, Singapore, South Korea, and Taiwan has expanded the group of Asian nations joining Japan, Australia, and New Zealand as developed. However, debate continues within the investment world as to whether South Korea and Taiwan should be classified as developed. Through the end of 2009, MSCI continued to classify South Korea and Taiwan as emerging, though FTSE moved South Korea to developed in late 2009 and Taiwan remains on its developed “watch list.”

The rapid growth of India and China means that in another 10 years two giant economies will have cities that are nearly developed but located in countries that will be emerging for several more decades. That doesn’t even take into account the fact that Hong Kong arguably can be considered both developed and emerging, depending on your viewpoint of its status as a “Special Administrative Region.”

Perhaps GDP per capita is an outdated methodology for dividing the world between developed and emerging countries, and investment index and mandate construction around these lines is shortsighted. In Asia, drawing a sharp line between developed and emerging is almost impossible—and we believe more importantly, irrelevant.

Investment Implications

The initial impetus behind global diversification focused on countries. Because economies and markets of various countries do not move in tandem, U.S.-based investors’ portfolios benefit. The recent global financial crisis painfully highlights that correlations between developed and emerging countries have increased. Over the past 10 years, the correlation between the United States (S&P 500 Index) and developed (MSCI EAFE Index) and emerging (MSCI EM Index) markets has been 0.88 and 0.80, respectively. Moreover, we’ve witnessed a rise in correlation between developed markets and emerging markets, which over this time period was 0.88—compared to 0.53 for 1989–1999. It is possible that the next 10 years will bring lower correlations of international markets with the United States. As financial systems such as Asia’s mature, become less dependent on the United States, and demonstrate continued domestic growth, capital markets also may become less similar.

Beyond mere geographic diversification, true global diversification therefore should be expanded to include other factors. Does the international strategy being employed counter U.S. investment strategies by offering exposure to domestic growth (versus U.S.-led export-oriented growth)? Does it provide exposure to mid- and small-cap companies that may be the global large-caps of tomorrow? Can it provide diversification into currencies that complement the investor’s U.S.-dollar exposure?

So how can you gain exposure to the major markets of the world in a way that captures investment opportunity and provides true global diversification by considering geography and other factors? **Invest globally by strategy.** Instead of treating a region such as Asia as an investment destination within an international allocation, consider how you can enhance your existing investment strategies (i.e., income and small companies) with exposure to Asian offerings. For example, the pool of dividends available to a U.S.-based dividend strategy literally can be doubled by expanding the universe of dividend-paying stocks to include Asia. Furthermore, the growth rates and stability of dividends in Asia may be higher than those in the United States. While investing by strategy can help better capture overlooked investment opportunities globally, communicating this approach can be more challenging with clients accustomed solely to the traditional international/U.S. asset allocation construct.

**Invest globally by region.** Split the world into three main blocs—United States, Europe, and Asia Pacific. A simple breakdown into thirds brings the portfolio fairly close to the world GDP breakdown, and investors can select experts in particular regions. One disadvantage is that it doesn’t capture Canada, Latin America, the Middle East, or Africa. A wealth of U.S. mutual funds that cover the world this way currently does not exist, but this is changing. A final drawback is the need to rebalance the regional allocations to the preferred strategic allocation.

**Complement core international strategies with regional or country funds.** This is the easiest and most popular method of migrating an overall portfolio to a desired international weighting and exposure. Depending on the core international funds used, increasing the portfolio’s existing Asia underweighting might involve adding Asia Pacific as a whole, Asia ex-Japan, or just China and India—the countries that tend to be most underrepresented relative to their economic size. This has the advantage of customizing to the desired country and risk factor exposures, but is a disadvantage if the investor is more comfortable delegating the allocation decision.

**Conclusion**

The benefits of global diversification in a portfolio are enduring. However, it is important to understand the growth and risk exposure offered by your current
approach. Many investors find that their broad-based international and emerging markets mandates leave them much less exposed to markets such as China and India—and other markets in Asia poised to benefit from these emerging powerhouses. How you can best improve upon your current approach requires careful consideration. While part of the decision is striking a balance between controlling and delegating allocation decisions, the key is to develop a methodology that fits the ultimate investment goal.

Jodi L. Borkowitz, CFA®, CFP®, is a senior vice president of Matthews International Capital Management, LLC, where she leads the firm’s sales and client service efforts. She earned a BA with honors in mathematics and economics from Northwestern University. Contact her at jborkowitz@matthewsasia.com.

Robert J. Horrocks, PhD, is chief investment officer at Matthews and co-manager of the Matthews Asian Growth and Income Fund. He earned a PhD in Chinese economic history from Leeds University in the United Kingdom and is fluent in Mandarin. Contact him at rhorrocks@matthewsasia.com.

Disclosure: The views and information discussed in this report are as of the date of publication, are subject to change and may not reflect the writer’s current views. The views expressed represent an assessment of market conditions at a specific point in time, are opinions only and should not be relied upon as investment advice regarding a particular investment or markets in general. Such information does not constitute a recommendation to buy or sell specific securities or investment vehicles. The subject matter contained herein has been derived from several sources believed to be reliable and accurate at the time of compilation. Matthews International Capital Management, LLC does not accept any liability for losses either direct or consequential caused by the use of this information.

To take the CE quiz online, visit www.IMCA.org.